Written Statement by the Securities Industry and Financial Markets Association (SIFMA)

Committee on Ways and Means

"The U.S. - China Economic Relationship"

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Submitted by the Securities Industry and Financial Markets Association (SIFMA)
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SIFMA Testimony for House Ways and Means Full Committee Hearing: The U.S. – China Economic Relationship

The Securities Industry and Financial Markets Association (SIFMA)[1] appreciates the opportunity to submit written testimony to the House Ways and Means Committee on China's capital markets and the benefits to both the U.S. and Chinese economies of opening China's financial markets. Our testimony will focus on the goals and objectives of the securities industry in our growing relationship with China's economy. We welcome and appreciate the Committee's interest in this important issue.

SIFMA has long supported more open, fair and transparent markets, and has strongly advocated liberalization of financial services in U.S. multilateral, regional and bilateral trade forums. The economic benefits of financial services sector liberalization reverberate throughout the world in the form of higher growth and greater opportunities. Financial services liberalization leads to new entrants, increased competition, capital markets with greater depth and efficiency, and improved access to financial services for citizens.

In the global economy, capital markets facilitate economic growth and development by substantially broadening the range of vehicles for savings and investment and lowering the cost of capital for businesses and entrepreneurs.

China's World Trade Organization (WTO) 2001 accession commitments for financial services, and more specifically for the securities industry, demonstrated a reluctance to open this sector fully to foreign competition. China's reluctance to open its securities markets fully to foreign investment has slowed the pace of reforms in China's capital markets. We believe China should improve and accelerate its financial sector reform so that it will have the financial tools necessary to sustain and improve the quality of its economic growth.

China's WTO Commitments for Foreign Securities Firms

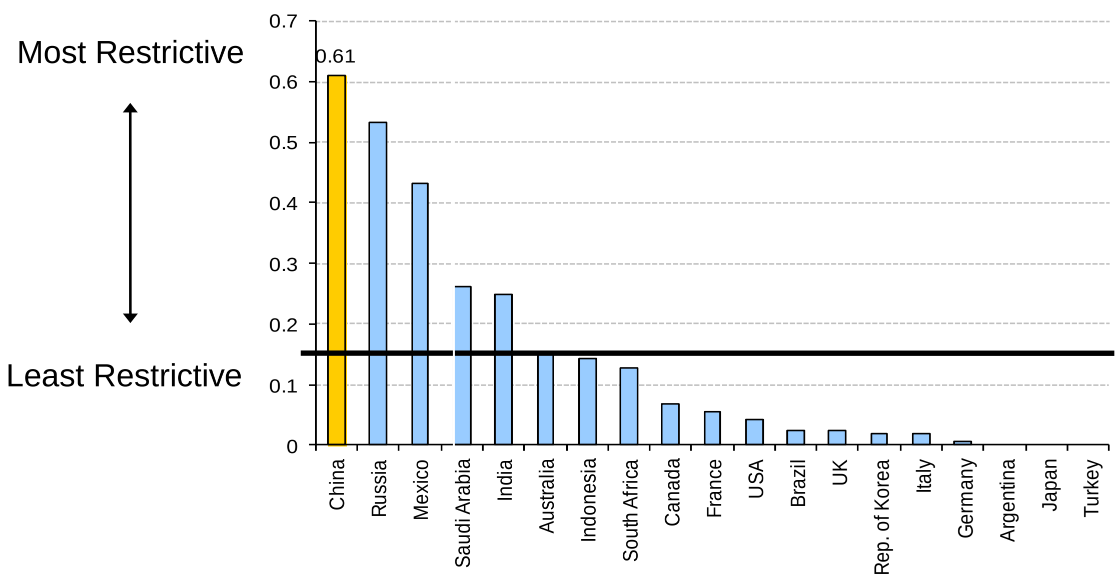
China's 2001 WTO entry commitments in the securities and asset-management sectors marked the country's first step toward liberalizing its capital markets. The commitments permit foreign firms to participate in the securities sector only through joint ventures

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA").

(JVs) in which foreign ownership is capped at 33 percent — although as more fully described below, the scope of securities activities in which these joint ventures can participate is limited. China's WTO commitments also limit foreign participation in China's asset-management sector to ownership of no more than 49 percent of domestic fund management firms.

These WTO commitments make no provision for further increases in foreign ownership in either securities or asset-management firms. Instead, the commitments suggest that without a change in policy, foreign investors will remain minority shareholders in local securities firms for the foreseeable future. Indeed, China remains one of the few markets of interest to the securities industry where majority ownership is not permitted, and compares unfavorably with access to our other G20 partners.

Figure 1: Restrictiveness in Financial Markets



Source: Blanka Kalinova, Angel Palerm and Stephen Thomsen (2010), "OECD's FDI Restrictiveness Index: 2010 Update", OECD Working Papers on International Investment, No. 2010/3, OECD Investment Division, www.oecd.org/daf/investment

China's WTO commitments in the securities sector also limit these minority-owned JVs to underwriting the A shares of Chinese corporations, and to underwriting and trading government and corporate debt, B shares and H shares. The fundamental ability to trade in A shares was not conferred on these minority JVs. (A shares are Renminbi (RMB)-denominated shares limited to domestic investors, foreign financial firms with qualified foreign institutional investor (QFII) status, and foreign strategic investors. B shares are foreign-currency denominated shares listed on PRC exchanges and are open to both domestic and foreign investors. H shares are shares of PRC companies listed in Hong Kong).

Financial sector liberalization will foster the development of strong financial markets and a competitive and efficient securities industry. We would urge China to take additional steps to modernize and strengthen its capital markets. First, better market access would allow foreign securities firms to compete in a fair manner with local firms. Second, market reform measures would improve the quality of regulation and increase transparency.

Expansion and Opportunity Abroad

While China has been slow to provide market access for foreign firms, it is moving rapidly to expand its global presence. In the past year, the Industrial & Commercial Bank of China has acquired a U.S. broker-dealer, a U.S.-based depository institution, and is expanding its presence in the European Union with branches in Paris, Brussels and Amsterdam. The Federal Reserve also recently approved a branching application for the Bank of Communications to establish a federal branch in San Francisco.[2] SIFMA supports the ability for financial services firms to choose their corporate form (e.g., a 100%-owned subsidiary, a branch or a joint venture) and be treated no less favorably than domestic suppliers (i.e., national treatment). To level the playing-field, we believe it is essential that China also takes steps to ensure foreign firms have access to its market.

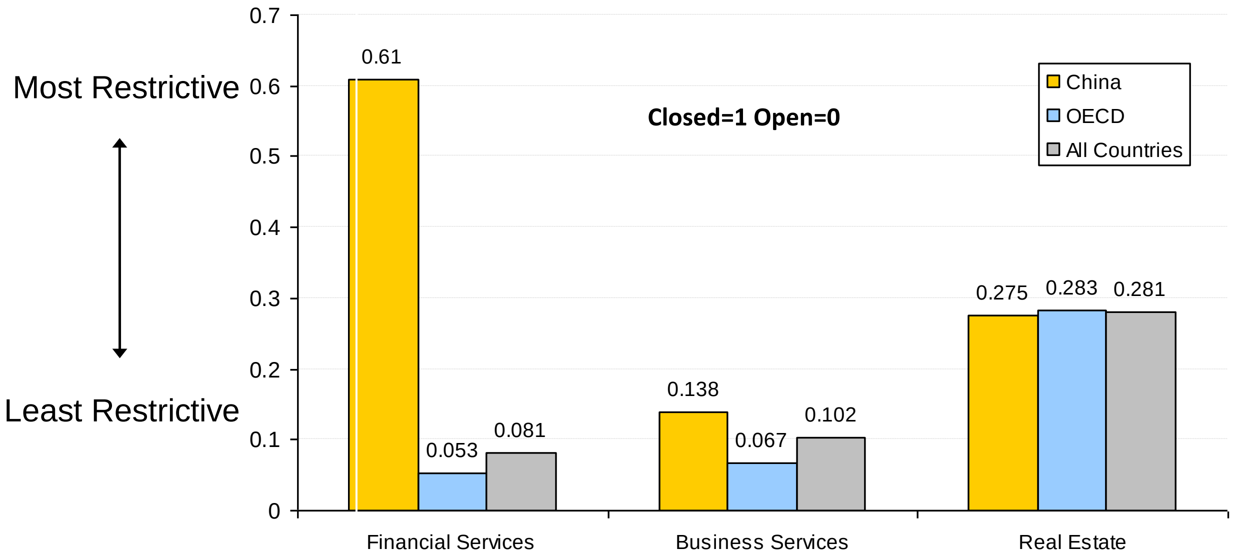
China is also striving to create a world-class financial exchange through the implementation of the Shanghai Stock Exchange Strategic Plan. The plan is intended to develop "one of the most influential bourses in the world, boasting a mature stock market, an improved bond market, a highly developed fund market, an abundance of securities derivatives and an increasingly rational investor structure."[3]

We believe the increased global profile of China's economy and capital markets – underscored by its Financial Stability Board (FSB) membership, and its recent appointment to IOSCO's Technical Committee – should be met with a corresponding

[2] http://www.federalreserve.gov/newsevents/press/orders/order20110408.pdf
[3] *Shanghai bourse eyes Asia's top market by 2020*, http://bit.ly/hOeMC8, Accessed February 10, 2011.

reduction and elimination of discriminatory barriers to foreign firms. While we appreciate and encourage Chinese participation in the international financial community, we believe this leadership role should come with greater respect for the benefits of the global rules-based system and an increased commitment to financial sector liberalization and promoting a level playing field within its domestic market.

Figure 2: Restrictiveness by Industry (FDI Index)



Source: Blanka Kalinova, Angel Palerm and Stephen Thomsen (2010), "OECD's FDI Restrictiveness Index: 2010 Update", OECD Working Papers on International Investment, No. 2010/3, OECD Investment Division, www.oecd.org/daf/investment

Recommendations

- *Permit Full Ownership and the Right to Choose Corporate Form*
  China should put in place a precise and transparent roadmap, on an agreed-to timetable, that would result in providing foreign securities firms with the right to own 100 percent of a PRC financial services firm, including the ability to engage in a full range of securities activities, including underwriting, secondary trading of government and corporate debt and all classes of equity, hybrid mortgage products, derivatives trading, and asset management.

  The right to enter a market and establish a wholly owned presence in a form of the firm's own choosing is relatively common in today's global markets. Currently, foreign investors can enter China's securities markets in two ways: by establishing a new JV with a Chinese partner or by taking a stake in an existing brokerage, the path that a number of foreign securities firms have chosen. Because in most cases the negotiations that result in a JV or a foreign stake are opaque, however, potential entrants have little available in the way of guidance on how to arrange such JVs. Similarly, foreign asset-management firms should be permitted to manage money for Chinese investors, both retail and institutional, as well as to sell internationally diversified mutual funds to individuals through qualified local distributors.

- *Liberalization of Qualified Foreign Institutional Investors (QFII) Standards*
  China's decision to permit foreign investment in A shares through QFIIs beginning in 2003 was a landmark step in the development and liberalization of China's capital markets. More recently, PRC authorities have taken steps to increase the number of QFIIs and the amount invested by QFIIs. Nevertheless, QFII requirements are onerous and have limited the utility of the program, as well as the number of investors that can take advantage of it, despite recent changes.

  China would make its securities markets more attractive to investment through the liberalization of QFII restrictions. Such progressive liberalization, done in consultation with foreign and domestic capital markets participants, would almost certainly result in greater foreign investment in China's securities markets, deepen and broaden trading in those markets, and increase capital availability to Chinese issuers.

- *Promote Regulatory Transparency*
  Transparent and fair regulatory systems play an integral role in the development of deep and liquid capital markets that attract market participants, increase efficiency and spur economic growth and job creation. Lack of transparency in the implementation of laws and regulations can seriously impede the ability of securities firms to compete fairly. On the other hand, transparency instills the confidence needed to attract both the suppliers and users of capital to make the best use of the markets. Securities firms are often confronted with non-tariff barriers in the form of regulatory restrictions, and lack of transparency in the implementation and application of regulations. These barriers prevent

access in much the same way as tariffs, but unlike tariffs, no quantitative mechanism exists to reduce them.

- *<u>Further Improve Bond Market Depth/Liquidity/Efficiency</u>*
  China is striving to expand its domestic bond and capital markets on par with global leaders. Great strides and significant progress has been made toward the goals of modernization and the attainment of global best practices. However, China's advancement continues to be hindered by discriminatory rules and policies which disadvantage foreign banks, especially with respect to bond underwriting and derivatives trading. In addition, if China's sometimes opaque regulatory system is not reformed, it will seriously impede the future development of the financial markets.

The Need for Continued Engagement in China

Fair and competitive access to China's fast-growing middle class and business sector represents an enormous commercial opportunity for American businesses, especially for the financial services sector. China's economy is one of the world's largest and is currently the largest export market outside of North America for American goods and services. As China's economy continues to grow, it is imperative that our firms establish a foothold to help finance new and existing businesses and infrastructure, offer new vehicles for savings and investment for China's 1.3 billion citizens, and contribute our expertise and best practices to Chinese financial services firms.

Chinese citizens lack adequate resources to save and invest. The lack of developed financial options leads to economic imbalances within the country that may ultimately constrain economic growth. Foreign financial institutions operating in China are currently offering products to Chinese citizens and businesses that allow them to save and invest, allowing for a necessary shift from an export based economy to one focused on consumption. This shift is beneficial to both the Chinese and American economies as it opens up opportunities for U.S. manufacturers and service providers.

The establishment of a financial system that does not impose restrictions on ownership and includes a robust supervisory regime with clear, transparent rules, and promotes entrepreneurial spirit and innovation is essential to the development of strong capital markets. It will help to ensure continued growth in one of the world's most important and interconnected economies and expanded opportunities for U.S. firms operating in the Chinese market.

SIFMA continues to support the Strategic and Economic Dialogue (S&ED) as an important forum to address barriers faced by the U.S. financial services sector. The removal of ownership and other market access restrictions in China remains a top priority for the industry, and we continue to value the opportunity the S&ED provides to raise and resolve our issues.

Conclusion

We appreciate the Committee's interest in this issue, and the opportunity to present this statement. We look forward to working constructively with this Committee on issues related to the global financial markets in the future.